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No. 74-799

In the Supreme Court of the United States

OCTOBER TERM, 1974

UNITED STATES OF AMERICA, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

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Section 172(b)(2) requires that when a taxpayer carries back a net operating loss to a year in which it has both ordinary income and capital gains, the loss deduction available for carryover to a succeeding year is the amount by which the loss exceeds the taxpayer's "taxable income"—ordinary income plus capital gains—for the prior year	11
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OPINIONS BELOW

The memorandum and order of the district court, and the stipulation of facts to which it refers (Pet. App. A 1a–7a) are not reported. The opinion of the court of appeals (Pet. App. B 8a–14a) is reported at 500 F. 2d 1230.

JURISDICTION

The judgment of the court of appeals was entered on July 29, 1974 (Pet. App. C 15a–16a). On October 17, 1974, Mr. Justice Blackmun extended the time for filing a petition for a writ of certiorari to and including December 26, 1974. The petition for a writ

of certiorari was filed on December 24, 1974, and was granted on March 31, 1975 (A. 21). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 172 of the Internal Revenue Code of 1954 permits the carryback of a net operating loss to a taxable year prior to the year in which the loss is sustained, and a carryover to a succeeding year of the amount, if any, by which the loss exceeds the taxable income for each prior year to which the loss may be carried.

The question presented is whether, in carrying back a net operating loss to a year in which the taxpayer had both ordinary income and capital gains and employed the alternative tax computation method of Section 1201, the loss deduction available for carryover to a succeeding year is the amount by which the loss exceeds the taxpayer's taxable income (ordinary income plus capital gains) for the prior year, or, as the decision below held, the amount by which the loss exceeds only the ordinary income for the prior year.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 11, 63, 172, 1201 and 1202 of the Internal Revenue Code of 1954, and of the Treasury Regulations on Income Tax, Sections 1.172–4(b)(1)(ii) and 1.172–5(a) (1) and (3), are set forth in the Appendix, *infra*.

BEST COPY AVAILABLE

STATEMENT

Respondent is in the lumber business (Pet. App. A 4a).[1] For its taxable years ended March 31, 1966 through July 19, 1968, it reported the following amounts of ordinary income and capital gains (Pet. App. A 4a):

Taxable year	Net ordinary income	Excess of net long-term capital gain over net short-term capital loss	Total taxable income or loss
1966	$7,236.05	$166,634.81	$173,870.86
1967	114,261.82	114,655.96	228,917.78
1968	(42,203.12)		(42,203.12)

Because respondent sustained a net operating loss of $42,203.12 for its taxable year 1968, it carried back that loss to 1966 and recomputed its tax liability for that earlier year. Accordingly, respondent filed Form 1139 (Corporation Application for Tentative Refund from Carryback of Net Operating Loss). As the Code prescribes, respondent recomputed its tax liability for 1966 under the method provided by section 11 (the so-called "regular method"), and the "alternative tax computation" provided by Section 1201 of the Code. Taking into account the carryback of the 1968 net operating loss of $42,203.12, respondent's computations of its 1966 income tax liability under each of the two methods were as follows (Pet. App. A 5a):

[1] The parties submitted the case to the district court on a stipulation of facts (Pet. App. A 3a–7a).

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"Regular Method" (Section 11)

Taxable Income (excluding net operating loss deduction):		
Ordinary Income	$7,236.05	
Capital Gains Income	166,634.81	
		$173,870.86
LESS: Net Operating Loss Deduction Resulting From Carryback of 1968 Net Operating Loss		(42,203.12)
Taxable Income (Section 63(a))		$131,667.74
Regular Tax (1966 rates)		$ 58,200.52

"Alternative Method" (Section 1201)

Taxable Income (excluding net operating loss deduction):		
Ordinary Income	$7,236.05	
Capital Gains Income	166,634.81	
		$173,870.86
LESS: Net Operating Loss Deduction Resulting From Carryback of 1968 Net Operating Loss		(42,203.12)
Taxable Income (Section 63(a))		$131,667.74

(Step 1—Partial Tax)

LESS: Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss	$166,634.81
Balance	($ 34,967.07)
Partial Tax at Section 11 Rates on Balance (Section 1201(a)(1))	-0-

(Step 2—Capital Gains Tax)

PLUS: Capital Gains Tax at Flat 25 Percent Rate on Excess of Net Long-Term Capital Gain Over Net Short-Term Capital Loss (Section 1201(a)(2))	$ 41,658.70
Alternative Tax (Sum of Partial Tax and Capital Gains Tax) (1966 rates)	$ 41,658.70

Since the $41,658.70 tax computed under the "alternative method" of Section 1201 was lower than the $58,200.52 tax computed under the "regular method" of Section 11, respondent was required to, and did, report the amount of alternative tax computed under the provisions of Section 1201 as its recomputed 1966 tax liability (Pet. App. A 4a–5a).

This suit involves respondent's tax liability for its taxable year ended March 31, 1967, the year immediately following the earliest year to which the 1968 net operating loss had been carried back. In applying for a tentative refund from the carryover of a net operating loss to that year, respondent claimed that $34,967.07 of its total 1968 loss of $42,203.12, which had been carried back to 1966, was still available to offset income for 1967. Respondent based its claim on the contention that its 1968 loss had been "used" in 1966 only to the extent of its ordinary income of $7,236.05 for that year (Pet. App. A 6a).

On audit, the Commissioner of Internal Revenue disallowed respondent's claim for refund for its taxable year 1967 (Pet. App. A 7a). The Commissioner's disallowance was premised on the terms of Section 172(b)(2), the statute governing the carryover and carryback of net operating losses. That statute provides that the portion of the loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of the loss over the sum of the "taxable income" for each of the prior taxable years to which such loss may be carried. Since respondent's 1968 net operating loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, the Commissioner determined that respondent's 1968 net operating loss had been entirely "used" to offset its taxable income for 1966. As a result, no part of the 1968 net operating loss deduction was available to respondent to carry forward from its taxable year 1966 to 1967.

The district court upheld respondent's claim for refund (Pet. App. A 1a–3a) and the court of appeals

affirmed (Pet. App. B 8a–14a). In concluding that respondent still had $34,967.07 of its 1968 loss available to offset income for 1967, the court of appeals acknowledged that "its interpretation of section 172 (b)(2) is counter to the position announced in Treasury Regulation 1.172–4(b)(ii) * * *" (Pet. App. B 11a). However, the court of appeals was strongly influenced by the fact that the courts that had then considered the issue had rejected the government's position. It therefore concluded that it could not "dismiss lightly the cumulative weight of our fellow judges' decisions or the divisiveness and administrative confusion that a contrary conclusion at this point might foster" (Pet. App. B 13a–14a). Shortly thereafter, however, the Fourth Circuit upheld the government's position in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, 505 F. 2d 128.

SUMMARY OF ARGUMENT

During its taxable years 1966–1968, respondent had the following income and losses:

1966	$173,870.86
1967	228,917.78
1968	(42,203.12)

In accordance with the highly detailed provisions of Section 172 of the Internal Revenue Code, which govern the carryback and carryover of net operating losses, respondent "carried back" its 1968 loss to 1966. The question presented, upon which the courts of appeals have divided, is the correct amount, if any, of the 1968 loss remaining for "carryover" to offset respondent's taxable income for 1967. We submit that

respondent had no loss carryover available to 1967 because its taxable income for 1966 exceeded the amount of its 1968 loss. Thus, the 1968 loss was completely "absorbed" upon its carryback to 1966 and there was no remaining portion of that loss available for carryover to 1967. The Fourth Circuit has so held on parallel facts in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, 505 F. 2d 128.

The decision below held, however, that the $42,203.12 loss was only "absorbed" to the extent of respondent's ordinary income for 1966—$7,236.05. It thereby concluded that respondent had a $34,967.07 ($42,203.12 less $7,236.05) loss carryover available to offset its income for 1967.

1. The decision below contravenes the explicit terms of Section 172(b)(2), which governs this case. That provision states that the amount of a loss carryover in these circumstances is "the excess, if any, of the amount of such loss over the sum of the *taxable income* for each of the prior taxable years to which such loss may be carried" (emphasis supplied). The term "taxable income" as used in Section 172(b)(2) is defined by Section 63(a) of the Code to mean "gross income, minus the deductions allowed by this chapter * * *." Under this definition, "taxable income" encompasses "all income from whatever source derived" (see Section 61(a)), which would include both ordinary income and capital gains.

Here, it is undisputed that respondent's 1966 taxable income was $173,870.86, the sum of its net ordinary income and capital gains. Since its 1968 loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, there was no "excess" of the loss over taxable income to

be carried over to 1967. Thus, under Section 172(b)(2) respondent had no loss carryover from 1966 to 1967.

Contrary to the decision below, the fact that respondent employed the Section 1201(a) alternative tax computation for 1966 does not call for a different result. That provision permitted respondent to compute its 1966 tax as the sum of (1) a "partial" tax at the regular Section 11 rates imposed on its taxable income less net long-term capital gains; and (2) a flat 25 percent tax on its net long-term capital gains. But the particularized "partial" tax computation does not alter the meaning of "taxable income" as that term is defined in Section 63(a) and used in Section 172 (b)(2). Whether the alternative or the regular tax computation is applicable for the carryback year, a corporation's "taxable income" continues to be its gross income—which would include both its ordinary income and long-term capital gains—less allowable deductions. Indeed, the first mathematical operation of the computation prescribed by Section 1201(a)—the subtraction of the 1968 loss of $42,203.12 from the taxable income of $173,870.86, to yield a recomputed taxable income of $131,667.74—demonstrates that no part of the loss remained to offset income by carryover to 1967.

2. The only detailed judicial exposition in support of respondent's position is the secondary holding of the Tax Court in *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 356–358, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1). There, the Tax Court concluded that the last phrase of Section 172(b)(2), "to which such loss may be carried," modifies the phrase

"taxable income" as well as the words "prior taxable years." Under that analysis, the only taxable income for the prior year to which the net operating loss is carried is the $7,236.05 of ordinary income upon which the "partial" tax of Section 1201(a) would have been computed in the absence of the loss carryback. In the Tax Court's view, a loss carryback is only "used" to the extent it reduces the Section 1201(a) partial tax base and affects the alternative tax computation for the prior year.

The Tax Court's construction construes Section 172 (b)(2) as if it read "* * * the sum of the taxable income [to which such loss may be carried] for each of the prior years to which such loss may be carried." In the absence of any legislative history warranting such a strained construction, its use hardly comports with this Court's oft-repeated admonition that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner,* 331 U.S. 1, 6.

Moreover, the Tax Court's construction is contrary to the usage employed by Section 172 and by the Code generally, in which a loss is "deducted" from income and not "carried" to taxable income. On the other hand, the term "carried" has always borne a temporal connotation of a transfer of a loss from the year in which it occurred to another year.

3. The error of the decision below is also illustrated by the fact that it permitted respondent to carry over a loss from 1963 to 1967 even though it would have had no "net operating loss" for 1966, as that term is defined by Section 172(c), if the loss had been sus-

tained in that earlier year. Section 172(b)(1) provides that . "net operating loss" for a particular year shall be a "net operating loss carryback" to prior years or a "net operating loss carryover" to succeeding years. Without a "net operating loss", there can be no carryback or carryover.

But under Section 172(c), a net operating loss is "the excess of the deductions allowed by this chapter [Sections 1–1388] over the gross income." There would have been no "excess" of deductions ($42,203.12) over gross income ($173,870.86) for 1966 within the meaning of Section 172(c) which would have qualified as a net operating loss carryover to 1967. The result should be the same here where the 1968 loss is taken into account in computing respondent's 1966 tax liability. After the carryback of that loss, respondent had no "excess" of deductions over gross income. Indeed, this statutory analysis is confirmed by the congressional understanding that no net operating loss deduction can be carried from a year in which the taxpayer does not suffer a loss.

Finally, the decision below permits a loss to offset income in another taxable year when that loss could not be used to offset the income of the year in which the loss was sustained, if the alternative tax computation were applicable. For example, if respondent incurred its $42,203.12 operating loss in 1966 instead of 1968, it could not offset it against its capital gains which were subject to the flat 25 percent tax. That rule was judicially established more than 20 years ago and is not challenged here.

If respondent could not have used the $42,203.12

loss in 1966 to offset its capital gains and thereby reduce its effective tax rate, it would be anomalous to allow it to carry such a loss forward to 1967 and possibly beyond, for use in offsetting income subject to a higher effective tax rate. Without an explicit congressional direction, the Code should not be construed to allow the very pyramiding of the benefits of the net operating loss carryback deductions and the alternative tax computation that is unavailable if the loss and capital gains occurred in a single taxable year.

ARGUMENT

SECTION 172(B)(2) REQUIRES THAT WHEN A TAXPAYER CARRIES BACK A NET OPERATING LOSS TO A YEAR IN WHICH IT HAS BOTH ORDINARY INCOME AND CAPITAL GAINS, THE LOSS DEDUCTION AVAILABLE FOR CARRYOVER TO A SUCCEEDING YEAR IS THE AMOUNT BY WHICH THE LOSS EXCEEDS THE TAXPAYER'S "TAXABLE INCOME"—ORDINARY INCOME PLUS CAPITAL GAINS—FOR THE PRIOR YEAR

A. INTRODUCTION

The question presented in this federal income tax case is technical and computational in character. It involves the operation of the provisions of the Internal Revenue Code governing the carryback and carryover of net operating losses (Section 172) and those prescribing the computation of the alternative tax on capital gains (Section 1201). While each of these two statutory provisions has been separately applied without judicial disagreement, the courts of appeals have divided on the question of the amount of a net operating loss deduction available for carryover to a succeeding year after the carryback of a loss to a prior

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year in which the taxpayer employs the alternative tax computation method of Section 1201.

The decision below held, in conformity with *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 356–358, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1), that the amount of the loss carryover available is the excess of the loss carryback over the ordinary income of the prior year. We submit that the contrary result reached by the Fourth Circuit in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* 505 F. 2d 128, correctly concluded that the amount of the loss carryover in these circumstances is the amount by which the loss carryback exceeds the ordinary income *and* net long-term capital gains of the prior year.

Before determining how Sections 172 and 1201 operate together in the context of this case, it is appropriate to consider first the circumstances under which they individually apply. Under the annual system of accounting upon which our income tax system is based, income and deductions must be reported with respect to a discrete taxable year. It is therefore possible for a taxpayer to sustain an economic loss over a period longer than a single taxable year and still bear a tax liability for a particular profitable taxable year falling within the longer loss period. See *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359.

The statutory mechanism for the carryback and carryover of losses is intended to mitigate the impact of the annual system of accounting. As this Court observed in *Libson Shops, Inc.* v. *Koehler,* 353 U.S. 382, 386, the net operating loss carryover and carryback provisions "were enacted to ameliorate the

unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year." [2]

The rules governing the carryover and carryback of net operating losses are set forth in Section 172 of the 1954 Code, Appendix, *infra,* pp. 36–38. That statute permits a net operating loss to be carried back to offset the income of the third taxable year preceding the year in which the loss is sustained. Section 172(b)(1)(A). To the extent that such a loss exceeds the taxable income of the preceding three years so that it is not earlier consumed, the remaining portion is available to be carried forward to each of

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[2] The first provision permitting the excess of expenses over income in one tax year to be deducted in another tax year was Section 204(b) of the Revenue Act of 1918, which permitted a one-year carryover and carryback. See Act of February 24, 1919, c. 18, Sec. 204, 40 Stat. 1060. In 1933, the National Industrial Recovery Act abolished all net operating loss carryovers and carrybacks. See Act of June 16, 1933, c. 90, Sec. 218(a), 48 Stat. 209. In 1939, a net operating loss carryover provision was reintroduced and provided for a two-year carryover. See Act of June 29, 1939, c. 247, Sec. 211, 53 Stat. 867.

Thus, the period of the carryback and carryover has ranged from the one-year carryback and one-year carryover permitted in 1918 to the three-year carryback and five-year carryover permitted since 1958. See 5 Mertens, *Law of Federal Income Taxation* (*Rev.*), § 29.01. The content and computation of the net operating loss deduction have varied both in concept and in detail. See, generally, 5 Mertens, *supra,* at c. 29; 1 Surrey, Warren, McDaniel and Ault, *Federal Income Taxation, Cases and Materials* 769–773 (1972 ed.). See also *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* 505 F. 2d 128, 136–138 (C.A. 4).

the five taxable years following the years in which the loss is sustained. Section 172(b)(1)(B). A net operating loss must be carried back to the earliest possible year to which it may be carried. Section 172(b)(1)(A).[3]

Section 1201(a) of the 1954 Code, Appendix, *infra*, pp. 38–39, is the second provision that comes into play in this case. That statute prescribes a so-called "alternative tax" for corporations on the excess of

[3] The operation of the loss carryover and carryback provision can be illustrated by the following example. Suppose a taxpayer has taxable income and losses for the period 1961–1969, as follows:

1961	$10
1962	10
1963	10
1964	(100)
1965	10
1966	10
1967	10
1968	10
1969	40

After the carryback of the 1964 loss to the years 1961–1963, the taxpayer would have consumed $30 of the $100 loss and would have available a $70 loss carryover to the five years succeeding 1964. That carryover would offset the total income for each of the years 1965–1968 and $30 of the income for 1969. The recomputed net income figures for the years 1961–1969, would be as follows:

1961	0
1962	0
1963	0
1964	0
1965	0
1966	0
1967	0
1968	0
1969	$10

the net long-term capital gains over the net short-term capital losses. This alternative tax is an exception to the general income tax imposed upon corporations by Section 11 of the Code, Appendix, *infra*, pp. 35–36.[4] As Section 1201(a) provides, the alternative tax is in "lieu of the tax imposed by sections 11 * * * (if such tax is less than the tax imposed by such sections) * * *." Thus, if a corporation has income from capital gains, it is required to compute its tax under both Sections 11 and 1201(a) and employ whichever method yields the lower liability.

The mechanics of the Section 1201(a) alternative tax computation involves a two-step process. First, a partial tax is computed on the taxable income reduced by the net long-term capital gains[5] at the regular corporate rates imposed by Section 11 (effectively leaving the ordinary income[6] subject to the partial tax). Secondly, a 25 percent tax is imposed on the net long-term capital gains. The alternative tax is the sum of the partial tax and the 25 percent tax on long-term capital gains. Thus, if a corporation had net long-term capital gains sufficiently in excess of $25,000,

[4] Pursuant to Section 11 (a), (b), (c), and (d), the corporate income tax rate during the period at issue was 22 percent of the first $25,000 of taxable income and 48 percent of the excess over $25,000.

[5] For purposes of simplicity, we use the term "net long-term capital gain" rather than the statutory phrase "excess of net long-term capital gain over net short-term capital loss."

[6] Strictly speaking, the Section 1201(a) "partial" tax base is taxable income less the excess of net long-term capital gains over net short-term capital losses. That base would therefore include short-term capital gains. However, because respondent had no short-term capital gains for 1966, we have referred to

which would be taxed at the regular 48 percent rate, it would be required to use the alternative tax.[7]

In this case, respondent sustained a net operating loss of $42,203.12 in 1968 and carried that loss back to 1966. Neither the amount of that loss nor its eligibility for carryback treatment is in dispute. What is at issue is the amount, if any, of the loss available for carryover to 1967. That amount depends upon how much of the 1968 loss was consumed to offset respondent's 1966 income, a year in which respondent employed the alternative tax computation of Section 1201.

Thus, the dispute focuses upon the mechanics of applying both the net operating loss carryback provisions of Section 172 and the alternative tax computation of Section 1201 for respondent's taxable year 1966. During that year, respondent received $7,236.05 of ordinary income and $166,634.81 of net long-term capital gains, for a total taxable income of $173,870.86.

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the Section 1201(a) partial tax base as imposed on "ordinary income".

[7] During the period at issue, the alternative tax would have been equal to the regular tax if the corporation had $28,260 of net long-term capital gains and no ordinary income. Under both methods, the tax would have been $7,065. Thus, assuming no ordinary income, the alternative tax would only be lower if the net long-term capital gains exceeded $28,260. That latter figure is derived from the following formula, where x equals the net long-term capital gains: $.25x = .22(25{,}000) + .48(x - 25{,}000)$. If a corporation has $25,000 of ordinary income so that each additional dollar of income would be taxed at the 48 percent rate, the 25 percent alternative tax would always yield a lower liability in the event it has any long-term capital gains.

Respondent contends, and the decision below held, that the $42,203.12 loss for 1968 was consumed in 1966 only to the extent of its ordinary income for that latter year, $7,236.05. If the 1968 loss were consumed only to this limited extent in its carryback to 1966, then respondent would still have a loss carryover of $34,967.07 ($42,203.12 less $7,236.05) available to offset income for 1967.[8]

However, we submit that respondent's 1968 loss of $42,203.12 was completely consumed upon its carryback to 1966 because its taxable income for that year—$173,870.86—far exceeded the amount of the carryback loss. As a result, there was no loss available for carryover to respondent's taxable year 1967. In our view, this result is explicitly mandated by the terms of Section 172(b)(2) and confirmed by the definition of "net operating loss" in Section 172(c). These statutory provisions, to which we now turn, demonstrate that respondent's 1968 loss was entirely consumed in its carryback to 1966.

B. THE LANGUAGE AND STRUCTURE OF SECTION 172 DEMONSTRATE THAT RESPONDENT DID NOT HAVE AVAILABLE A LOSS CARRYOVER TO 1967 BECAUSE ITS LOSS CARRYBACK TO 1966 DID NOT EXCEED ITS TAXABLE INCOME FOR THAT PRIOR YEAR

1. (a) The critical Code provision governing the amount, if any, of respondent's loss carryover to 1967 is Section 172(b)(2). That section, entitled "Amount of

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[8] Respondent had $114,261.82 of ordinary income and $114,655.96 of net long-term capital gains for 1967 (Pet. App. A 4a). Hence, there is no possibility that any portion of the 1968 loss would be available for carryover to years subsequent to 1967.

carrybacks and carryovers.—", states in pertinent part:

> The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

Thus, the amount of the net operating loss which may be carried over to succeeding years is the excess of the amount of the loss over the taxpayer's "taxable income" for the earliest year to which the loss is carried back.

The term "taxable income" is itself precisely defined in the Code. Section 63(a), Appendix, *infra*, p. 36, provides that 'taxable income" "means gross income, minus the deductions allowed by this chapter * * *." Under this definition, which is fully applicable to Section 172(b)(2),[9] "taxable income"

[9] The specific language of Section 63(a) applies its definition of "taxable income" to all sections of the Code contained in Subtitle A, which includes the provisions from Section 1 to and including 1564.

That the Section 63(a) definition is applicable to Section 172(b)(2) is further demonstrated by the use of the term "taxable income" in many other Code provisions. See, *e.g.*, Sections 3, 4, 56, 161, 170, and 211. Indeed, when Congress intended that the term "taxable income" was to depart from the Section 63(a) definition, it included an explicit modification. See, *e.g.*, Sections 593(b)(2)(E) (mutual savings banks), 832(a) (insurance companies), and 852(b)(2) (regulated investment companies).

The only modifications to "taxable income" contained within Section 172 are set forth in Section 172(b)(2)(B) (requiring the exclusion of the net operating loss for the current loss year

encompasses "all income from whatever source derived" (see Section 61(a)), which would include both ordinary income and long-term capital gains.[10]

It is undisputed that respondent's 1966 taxable income, as that term is defined by Section 63(a), was $173,870.86, the sum of its net ordinary income and long-term capital gains. Since its 1968 loss of $42,203.12 was less than its 1966 taxable income of $173,870.86, there was no "excess" of the loss over taxable income to be carried over to 1967.[11] Thus, the language of Section 172(b)(2) shows that respondent had no loss carryover from 1966 to 1967. Accord: Treasury Regulations on Income Tax, §§ 1.172–4(b)(1)(ii) and 1.172–5(a)(1) and (3) (26 C.F.R.), Appendix, *infra*, pp. 40–44.

The fact that respondent employed the Section 1201(a) alternative tax computation for 1966 does not permit a different result. That provision required respondent to compute its 1966 tax as the sum of (1) a "partial" tax at the regular Section 11 rates imposed on its taxable income less long-term capital gains; and

or any other year thereafter) and Section 172(d) (which applies only to corporations eligible for the special deductions under Sections 242 and 922 and the computations allowed by Sections 243, 244, 245, 246(b), and 247 of the Code). None of these departures from the Section 63(a) definition of "taxable income" is applicable here.

[10] The definition of gross income, as set forth in Section 61(a), is all-inclusive and encompasses gross income derived from business and gains derived from dealings in property. See Sections 61(a)(2), (a)(3).

[11] We discuss the effect of the final statutory phrase "to which such loss may be carried" at pp. 23–26, *infra*.

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(2 a 'capital gains" tax imposed at a flat 25 percent rate on the previously excluded capital gains. Thus, before taking the 1968 loss carryback into account, respondent's 1966 tax was the sum of (1) the Section 11 "partial" tax on $7,236.05 ($173,870.86 less $166,634.81); and (2) 25 percent of $166,634.81.

In holding that respondent had available a $34,-967.07 loss eligible for carryover to 1967, the decision below concluded that the proper computation for 1966 was to net the 1968 loss of $42,203.12 only against respondent's 1966 ordinary income of $7,236.05, because the Section 1201(a) "partial" tax would have been imposed only on the ordinary income segment of respondent's taxable income. But the particularized "partial" tax computation of Section 1201(a) does not alter the meaning of "taxable income" as that term is defined in Section 63(a) and used in Section 172(b)(2). Whether the alternative or the regular tax computation is applicable, a corporation's "taxable income" continues to be its gross income (less allowable deductions) which would include both ordinary income and capital gains. The court of appeals' restriction of "taxable income" to ordinary income is contrary to the definition of that term in Section 63(a).

Thus, even though respondent used the Section 1201 (a) alternative tax computation, its "taxable income" for 1966 continued to equal $173,870.86, in conformity with the definition of that term in Section 63(a). Since the $42,203.12 loss for 1968 was less than respondent's 1966 taxable income of $173,870.86, that loss was completely "absorbed" upon its carryback

to that prior year. Indeed, the first mathematical operation of the computation prescribed by Section 1201(a)—the subtraction of the 1968 loss of $42,203.12 from respondent's 1966 taxable income of $173,870.86, which reduced its taxable income for that year to $131,667.74—demonstrates that no part of the loss remained to offset income by carryover to 1967. See p. 4, *supra*. There was accordingly no "excess * * * of the amout of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried" within the meaning of Section 172(b)(2).

(b) Moreover, Section 172(b)(2) itself demonstrates that the term "taxable income" cannot be subjected to inferred modifications such as the subtraction of net long-term capital gains that the court of appeals imposed. The very next sentence of Section 172(b)(2) after the quoted portion on page 17, *supra*, begins "For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed —" and this clause is followed by several specific and detailed modifications. If the term "taxable income" is to be modified as the court of appeals provided, one would expect that the subtraction of net long-term capital gains from "taxable income" would have received explicit congressional sanction by inclusion in the list of statutory modifications. The absence of such a provision in a statute that is structured with precision and replete with detail strongly suggests that the term "taxable income" in Section 172(b)(2) must be given the meaning set forth in

Section 63(a) for purposes of the entire income tax subtitle.[12]

It was the definition of "taxable income" in Section 63(a) that led the Fourth Circuit in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner, supra,* 505 F. 2d 128, to uphold in an essentially identical case the statutory construction we urge here. More recently, the Sixth Circuit in *Axelrod* v. *Commissioner,* 507 F. 2d 884, has also refused to modify "taxable income" in an analogous case involving an individual taxpayer.

There, the taxpayer carried back a net operating loss to a year in which he had computed his tax liability under the alternative capital gains tax for individuals provided by Section 1201(b). Like Section 1201(a), which is applicable to a corporation, Section 1201(b) involves a two-step calculation in which a partial tax is computed on taxable income reduced by a particular deduction.[13] And like respondent, the tax-

[12] The care and precision with which Congress had delineated the net operating loss carryover and carryback provision leaves little, if any, room for independent inference in construing the statute. As a leading text has stated, "To understand the scope of the permissible net operating loss deduction for a particular taxable year it is necessary to define the terms 'net operating loss,' 'net operating loss carry-back' and 'net operating loss carry-over.' None of these terms may be defined simply, there being certain modifications (which were called exceptions, limitations and adjustments under the 1939 Code and which are called modifications under the 1954 Code), required in order to determine the amount of the loss which may be carried back or carried over and deducted in the taxable year." 5 Mertens, *supra,* § 29.02.

[13] The alternative tax for individuals provided by Section 1201(b), Appendix *infra,* p. 39, is the sum of (1) a partial tax at regular rates on the taxable income reduced by 50 per-

payer in *Axelrod* argued that his net operating loss was only "absorbed" to the extent of the segment of his income subject to the partial tax. However, the court rejected this contention, stating in terms pointedly appropriate to this case, "[t]axable income is the same regardless of the method of computation even though the amount of tax due may be different" (507 F. 2d at 887).[14] Thus, unless expressly modified by another provision of the Code, taxable income means net ordinary income plus net capital gains.

2. The court of appeals in this case did not consider the effect upon Section 172(b)(2) of the definition of "taxable income" in Section 63(a). Instead, it adopted the construction of Section 172(b)(2) formulated by the Tax Court in its secondary holding in *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 356–358, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1). There, the Tax Court concluded that the phrase of Section 172(b)(2), "to which * * * such loss may be carried," modifies the phrase "taxable income" as well as the words "prior taxable years." Pursuant to the Tax Court's analysis, which the First Circuit summarily affirmed because it viewed the question as "unimportant and seldom occurring" (428 F. 2d at 475),[15]

cent of the net long-term capital gains; and (2) a flat 25 percent tax on the net long-term capital gains.

[14] In *Axelrod*, the Sixth Circuit expressed agreement with the Fourth Circuit's holding in *Mutual Assurance.* See 507 F. 2d at 888.

[15] The Ninth Circuit has followed *Chartier* in two brief *per curiam* decisions. See *Olympic Foundry Co.* v. *United States,* 493 F. 2d 1247, and *Data Products Corp.* v. *United States,* decided December 27, 1974, No. 74–3341, petition for certiorari pending, No. 74–996. Accord: *Naegele* v. *United States,* decided August 6, 1973

the only taxable income for the prior year to which the net operating loss is "carried" is the $7,236.05 of ordinary income upon which the "partial" tax of Section 1201(a) would have been computed in the absence of the loss carryback. In the Tax Court's view, a loss carryback is only "used" to the extent it reduces the Section 1201(a) partial tax base and affects the alternative tax computation for the prior year.

This construction of Section 172(b)(2) is at odds with the plain meaning of that provision. The critical sentence of Section 172(b)(2) states:

> The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.

While the final phrase "to which such loss may be carried" modifies the immediately preceding term "prior taxable years,"[16] the Tax Court in *Chartier* held that the final phrase also modifies the words "taxable income." But the Tax Court's construction views the statute as if it reads—"* * * the sum of the taxable income [to which such loss may be carried] for each of the prior taxable years to which such loss may be carried." Such a strained construction hardly comports with this Court's admonition that "the

(D. Minn.), appeal pending, C.A. 8, No. 73–1921; and *Continental Equities, Inc.* v. *Commissioner*, 33 T.C.M. 812, appeal pending, C.A. 5, No. 75–1562.

[16] In parallel fashion, the final phrase "to which * * * such loss may be carried" in the first sentence of Section 172(b)(2) modifies only the immediately preceding term "the earliest of the taxable years."

words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses." *Crane* v. *Commissioner*, 331 U.S. 1, 6. See also *Hanover Bank* v. *Commissioner*, 369 U.S. 672, 687–688; *Commissioner* v. *Korell*, 339 U.S. 619, 627–628.

Indeed, if Congress had intended the final phrase "to which such loss may be carried" to modify "taxable income," one would suppose that the legislative history of Section 172 would have clearly so stated.[17] As the Fourth Circuit observed in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner, supra*, 505 F. 2d at 134, "[i]f Congress had intended to enact the rule in *Chartier Real Estate*, it certainly chose an obscure verbal formula to convey this meaning."[18]

[17] The phrase "to which such loss may be carried" was introduced into Section 172 at the time of the 1954 codification and there is no legislative history explaining its significance. The absence of any special meaning for the phrase led the Fourth Circuit to conclude that it was simply a substitute for the term "intervening years' which was used in the prior statute. Thus, the court concluded that the phrase "to which such loss may be carried" simply served to identify those years whose taxable income must be taken into account in a carryover or carryback computation. See Act of September 23, 1950, c. 994, Sec. 215, 64 Stat. 937. See *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, *supra*, 505 F. 2d at 134, and n. 10.

[18] Prior to the Tax Court's *Chartier* decision in 1969, the commentators had regarded Section 172(b)(2) as explicit in denying a net operating loss carryover in the circumstances of this case. See Herwitz, *Business Planning—Materials on the Planning of Corporate Transactions* 844 (1966); Hawkins, *Mechanics of Carrying Losses to Other Years*, 14 West. Res. L. Rev. 241, 250–251 (1963). For post-*Chartier* commentary, see *Significant Development*, 55 Boston Univ. L. Rev. 134 (1975); and recent cases, 8 San Diego L. Rev. 442 (1971). But compare Branda, *Net Operating Losses and Capital Gains—Some Bizarre Consequences of the Alternative Tax Computation*, 28 Tax Lawyer 455 (1975).

Moreover, the Tax Court's construction of Section 172(b)(2) is contrary to the overall structure of Section 172. According to the usage of the Code, and of Section 172 specifically, a loss is "deducted" from income; it is not "carried" to taxable income. See Section 172(a), (c), (d)(1). See also Sections 165, 267, and 1091. On the other hand, throughout Section 172, the term "carried" has the temporal connotation of a transfer of a loss from the year in which it occurred, and would normally be taken into account, to another year. For example, Section 172(b)(1)(A) and (b)(1)(B) respectively speak of a loss carryback or a loss carryover "to each of the 3 taxable years preceding the taxable year of such loss" and "to each of the 5 taxable years following the taxable year of such loss." See Sections 172(b)(1)(C), (D), (E), (b)(2) (first sentence), 381(c)(1), (3), and 382(b)(4). Accord: *Axelrod* v. *Commissioner, supra,* 507 F. 2d at 887, n. 2.

The decision below therefore erred in holding that respondent's net operating loss of $42,203.12 was selectively "carried" back to the $7,236.05 segment of ordinary income upon which its "partial" Section 1201(a) alternative tax would have been computed. That loss was "carried" back as a whole to the year 1966. It therefore had to be offset against the total amount of taxable income for that prior year rather than against a particular type of income received in that year. Since respondent's taxable income for 1966 ($173,870.86) exceeded its 1968 loss ($42,203.12), the loss was completely "absorbed" upon its carryback to 1966.

3. Finally, the structure of Section 172 provides

a further indication that the *Chartier* modification of "taxable income" adopted by the decision below is erroneous. In the case of a taxpayer other than a corporation, Section 172(d)(2)(B) states that in computing the taxable income for any prior year, "the deduction for long-term capital gains provided by section 1202 shall not be allowed." Section 1202, Appendix, *infra,* p. 39, permits a deduction of 50 percent of net long-term capital gains and is available only to non-corporate taxpayers. Thus, in computing the "taxable income" of a non-corporate taxpayer for a year to which a net operating loss is carried, Section 172(d)(2)(B) requires that, if the taxpayer has claimed the Section 1202 deduction, the full amount of ordinary income plus capital gains will be offset against the net operating loss.

If the decision below were correct in holding that the term "taxable income" means only ordinary income in the case where the alternative tax is applicable, Section 172 would accord markedly better treatment for corporations than individuals. An individual who claimed the Section 1202 deduction for 50 percent of his capital gains would be required to restore that amount to "taxable income" in computing a net operating loss carryover. Similarly, under *Axelrod* v. *Commissioner,* 507 F. 2d 884 (C.A. 6), an individual who used the alternative tax of Section 1201(b) would be denied the very net operating loss carryover allowed to a corporation by the decision below.

However, a corporate taxpayer, such as respondent, which employed the Section 1201(a) alternative tax would be permitted to exclude its entire net long-

term capital gains before determining the amount of its loss carryover. As the Fourth Circuit noted in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner,* supra, 505 F. 2d at 135, there is nothing to indicate that Congress intended the phrase "taxable income" to have one meaning for corporations and another meaning for individuals. Nor is there anything to suggest that Congress intended to favor corporations over individuals for purposes of the net operating loss deduction. A uniform application of the Section 63(a) definition of "taxable income" would avoid the discriminatory treatment produced by the decision below.

C. RESPONDENT DID NOT HAVE A LOSS CARRYOVER FROM 1966 TO 1967 BECAUSE IT WOULD HAVE HAD NO "NET OPERATING LOSS" FOR 1966 WITHIN THE MEANING OF SECTION 172(C) HAD THE LOSS BEEN SUSTAINED IN THAT EARLIER YEAR

The error of the decision below can also be illustrated by the fact that it permitted respondent to carry over a loss from 1966 to 1967 even though it could not have carried over that loss had it been sustained in 1966. This proposition can be demonstrated as follows: Section 172(b)(1) provides that a "net operating loss" for a particular year shall be a "net operating loss carryback" to prior years or a "net operating loss carryover" to succeeding years. Without a "net operating loss," there can be no carryback or carryover. Section 172(c), Appendix, *infra,* p. 38, defines a "net operating loss" as "the excess of the deductions allowed by this chapter [Sections 1–1388] over the gross income." Thus, a taxpayer does not

have a "net operating loss" for a particular year unless its deductions exceed its gross income as defined by Section 61, which would include its ordinary income *and* its capital gains.

How does the statutory definition of "net operating loss" affect respondent's claim to a loss carryover to 1967? For 1966, respondent's gross income was $173,870.86 and its only available deduction derived from its 1968 net operating loss carryback of $42,203.12. Had that loss occurred in 1966, respondent would have had no "excess" of deductions over gross income for 1966 within the meaning of Section 172(c) which would have qualified as a net operating loss carryover to 1967.

Under that provision, the equation—gross income less deductions—must yield a negative figure before a "net operating loss" arises for use as a carryover or carryback to offset income for other taxable years. Similarly, here, where the 1968 loss was carried back to 1966 and thereby taken into account in computing the tax liability for that prior year, the result should be the same as the case where the loss occurred in 1966. In both instances, respondent had no "excess" of deductions over gross income for that year. Thus, Section 172(c) effectively refutes respondent's claim to a net operating loss carryover to 1967 equal to the difference between its 1966 ordinary income ($7,236.05) and its 1968 net operating loss ($42,203.12).

This statutory analysis is confirmed by the congressional understanding that absent a pre-existing carryback or carryover, no net operating loss deduc-

tion can be carried from a year in which the taxpayer does not suffer a loss. See Detailed Discussion of Certain Technical Provisions of the Revenue Bill of 1939 (H.R. Rep. No. 855, 76th Cong., 1st Sess. 17 (1939)). The figures for 1966 demonstrate that even after respondent took its 1968 loss carryback into account, it did not suffer a loss for 1966 but in fact had net income of $131,667.74. Thus, there is no remaining loss available for carryover to offset income for 1967.

The applicability of the Section 1201(a) tax computation for 1966 cannot create a net operating loss where there is a net gain for that year. As this Court stated in *Reo Motors* v. *Commissioner,* 338 U.S. 442, 449, with respect to the net operating loss carryover, in terms equally applicable to this case, "We find no warrant for the view that Congress intended that a statute designed to equalize tax burdens should be used to produce net losses where none had previously existed."

Moreover, the decision below permits a loss to offset income in another taxable year when that loss could not be used to offset the income of the year in which the loss was sustained, if the alternative tax computation were applicable. This can be illustrated by the following example. Suppose respondent incurred its $42,203.12 operating loss in 1966 instead of 1968. Under the alternative tax computation, which would still be applicable for that year, respondent could not offset its ordinary loss against its capital gains which were subject to the flat 25 percent tax. That rule was established more than 20 years ago in

Weil v. *Commissioner,* 23 T.C. 424, affirmed, 229 F. 2d 593 (C.A. 6), with respect to an individual taxpayer. Indeed, the validity of the *Weil* rule is not challenged here, for it was applied by the Tax Court to a corporation in the first issue considered in *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346, 350–356, affirmed *per curiam,* 428 F. 2d 474 (C.A. 1).

If respondent could not have used the $42,203.12 loss in 1966 to offset its $166,634.81 of capital gains and thereby reduce its effective tax rate below the 25 percent preferential capital gains rate of the alternative tax, it would be anomalous to allow it to carry such a loss forward to 1967, for use in offsetting income subject to a higher effective tax rate.[19] In short, the court below has allowed the very pyramiding of the benefits of the net operating loss carryback

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[19] As the Fourth Circuit pointed out in *Mutual Assurance* (505 F. 2d at 136–138), the Revenue Acts from 1924 to 1934 permitted the excess of deductions over ordinary income to reduce the amount of capital gains subject to the alternative capital gains rate. These early Acts permitted net operating losses carried back or carried over to offset long-term capital gains both under the regular and under the alternative computations. As demonstrated both by the *Weil* decision and by the decision of the primary issue in *Chartier* under the 1939 and 1954 Codes, this deduction was eliminated. When the net operating loss was restored in 1939, the statute provided that the net operating loss could offset capital gains when taxed at regular rates, but not when taxed at the favorable alternative rates. Thus, the Fourth Circuit concluded with respect to the secondary holding in *Chartier* at issue here (505 F. 2d at 138): "The Tax Court's remedy is a ruling that such excess will be available in the future to offset ordinary income. Thus, the Tax Court has extended a greater benefit to the taxpayer than Congress did when it expressly addressed itself to this problem on a prior occasion, and we think incorrectly so."

deductions and the alternative tax computation that *Weil* foreclosed with respect to an ordinary loss and capital gains occurring in a single taxable year.[20]

Finally, the decision below unfairly elevates the status of the net operating loss carryback deduction over every other type of deduction against gross income permitted by the Code. For example, suppose that respondent had sustained a $1,000 ordinary loss for 1966 instead of the $7,236.05 of ordinary income it actually received. The large amount of capital gains for that year ($166,634.81) would continue to make the alternative tax computation applicable both before and after the carryback of the 1968 loss of $42,203.12. Under the *Weil* case, the $1,000 ordinary loss does not reduce the capital gains subject to the alternative tax and it cannot be carried forward to 1967 because there is no "excess" of deductions over gross income within the meaning of Section 172(c).

However, *Chartier* and the decision below would permit the $42,203.12 loss to be carried back to 1966 and, because it did not "affect" the alternative tax computation for that year, that loss could be carried forward to 1967. There is, in fact, no difference between the $1,000 loss sustained in 1966 and the $42,203.12 loss sustained in 1968. Both losses are

[20] The courts have generally foreclosed taxpayers' attempts to cumulate the benefits of the loss carryback and carryover provision with those of the capital gains provisions of the Code. See, *e.g.*, *Little* v. *Commissioner*, 294 F. 2d 661 (C.A. 9) and *Kaecker* v. *Commissioner*, 30 T.C. 897. See also *Payne* v. *United States*, 489 F. 2d 1404 (Ct. Cl.) (income averaging); *Estate of Gadlow* v. *Commissioner*, 50 T.C. 975 (averaging of breach of contract damages); and *Redpath* v. *Commissioner*, 19 T.C. 470 (averaging of back pay award).

ordinary deductions which are entitled to equal status in the Code[21] and both losses do not "affect" the alternative tax computation for 1966.

Thus, if the $1,000 loss cannot be carried forward to 1967, the $42,203.12 loss should likewise be ineligible for carryover to a succeeding year. In the absence of an explicit congressional direction to the contrary, there is no sound policy reason to construe the Code to require such unequal treatment of equivalent types of deductions against gross income.[22]

[21] See Section 161 which appears to suggest that all deductions are of equal rank or significance. It provides that "[i]n computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part [Sections 161–187] * * *." Cf. *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 17.

[22] The *Chartier* attempt to merge the net operating loss provisions with the alternative computation under Section 1201 produces strikingly disparate results arising from small differences in figures, as illustrated by the recent decision in *Lone Manor Farms, Inc.* v. *Commissioner*, 61 T.C. 436. If long-term capital gains are large, other income is small, and deductions are large, the regular tax computation under Section 11 may, and often will, produce the smaller tax, thereby making *Chartier* inapplicable.

In *Lone Manor Farms*, the taxpayer had net operating losses of $8,207.60 and $30,124.62 for 1965 and 1966, respectively. In 1967, it had taxable income of $259,621.12 prior to the application of the net operating losses of the preceding years. This included a net long-term capital gain of $313,531.39 and deductions in excess of ordinary income of $53,910.27. Applying the net operating losses of the preceding years, this produced a tax of $99,718.67 for 1967 when computed under the regular Section 11 method, but an alternative tax of $78,382.85 when computed under the alternative Section 1201 method. Consequently, the tax of $78,382.85 was paid. Pursuant to *Chartier*, the net operating loss carryovers from 1965 and 1966, aggregating $38,332.22, were available for further carryover since they were not "used" in the alternative computation.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed and remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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However, in 1968, the taxpayer had a further net operating loss of $30,529.78, in 1969 taxable income of $135,130.89 and in 1970 a net operating loss of $23,490.08. The taxpayer sought to apply its 1965 and 1966 net operating losses aggregating $38,332.22 (available under *Chartier*) and its 1968 and 1970 net operating losses aggregating $54,019.86 to offset its 1969 income. But when the 1968 and 1970 net operating losses were first carried back to 1967, as Section 172(b)(2) requires, and the 1967 tax recomputed, the regular computation under Section 11 produced a tax of $73,789.14, as compared with the alternative computation, so that the regular method was applicable.

Thus, under *Chartier*, the difference of $4,593.71 between the regular and the alternative methods of computing taxpayer's tax for 1967 governed the availability for other years of net operating losses aggregating $92,352.08. It seems hardly likely that such a small difference between the regular and the alternative tax should warrant such disparate results.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 11 [as amended by Sec. 121, Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, 25]. Tax Imposed.

(a) *Corporations in General.*—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) *Normal Tax.*—The normal tax is equal to the following percentage of the taxable income:

(1) 30 percent, in the case of a taxable year beginning before January 1, 1964, and

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) *Surtax.*—The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

(1) 22 percent, in the case of a taxable year beginning before January 1, 1964,

(2) 28 percent, in the case of a taxable year beginning after December 31, 1963, and before January 1, 1965, and

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

(d) *Surtax Exemption.*—For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the

surtax exemption for the taxable year is the amount determined under such section.

* * * * *

Sec. 63. Taxable income defined.

(a) *General Rule.*—Except as provided in subsection (b), for purposes of this subtitle the term "taxable income" means gross income, minus the deductions allowed by this chapter, other than the standard deduction allowed by part IV (sec. 141 and following).

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Sec. 172. Net operating loss deduction.

(a) *Deduction Allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) [as amended by Sec. 317(b), Trade Expansion Act of 1962, P.L. 87–794, 76 Stat. 872, 889, and Secs. 210(a) and 210(b), Revenue Act of 1964, *supra,* 78 Stat. 47–49] *Net Operating Loss Carrybacks and Carryovers.*—

(1) *Years to which loss may be carried.*—

(A)(i) Except as provided in clause (ii) and in subparagraph (D), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(ii) In the case of a taxpayer with respect to a taxable year ending on or after December 31, 1962, for which a certification has been issued under section 317 of the Trade Expansion Act of 1962, a net operating loss for such taxable year shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C) and (D), a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * * * *

(2) *Amount of carrybacks and carryovers.*—Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4) and (6) thereof; and

(B) by determining the amount of the net operating loss deduction—

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1)(D) applies, such portion shall be consid-

ered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss.

* * * * *

(c) *Net Operating Loss Defined.*—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) *Modifications.*—The modifications referred to in this section are as follows:

(1) *Net operating loss deduction.*—No net operating loss deduction shall be allowed.

(2) *Capital gains and losses of taxpayers other than corporations.*—In the case of a taxpayer other than a corporation—

* * * * *

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

* * * * *

Sec. 1201. Alternative tax.

(a) [as amended by Sec. 8(g)(3), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 999] *Corporations.*—If for any taxable year the net long-term capital gain of any corporation exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 11, 511, 821 (a) or (c), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of such excess, or, in the case of a taxable year beginning before April 1, 1954, an amount equal to 26 percent of such excess.

In the case of a taxable year beginning before April 1, 1954, the amount under paragraph (2) shall be determined without regard to section 21 (relating to effect of change of tax rates).

(b) *Other taxpayers.* If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, then, in lieu of the tax imposed by sections 1 and 511, there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of—

(1) a partial tax computed on the taxable income reduced by an amount equal to 50 percent of such excess, at the rate and in the manner as if this subsection had not been enacted, and

(2) an amount equal to 25 percent of the excess of the net long-term capital gain over the net short-term capital loss.

Sec. 1202. Deduction for capital gains.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 percent of the amount of such excess shall be a deduction from gross income. In the case of an estate or trust, the deduction shall be computed by excluding the portion (if any), of the gains for the taxable year from sales or exchanges of capital assets, which, under sections 652 and 662 (relating to inclusions of amounts in gross income of beneficiaries of trusts), is includible by the income beneficiaries as gain derived from the sale or exchange of capital assets.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.172–4 Net operating loss carrybacks and net operating loss carryovers.

* * * * *

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) * * *

(ii) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the aggregate of the taxable incomes (computed as provided in § 1.172–5) for all of such several taxable years preceding such subsequent taxable year which are subject to the Internal Revenue Code of 1954 and the aggregate of the net incomes (computed as provided in 26 C.F.R. (1939) 39.122–4(c) (Regulations 118) or in the corresponding section of prior applicable regulations) for all of such preceding taxable years which are subject to the Internal Revenue Code of 1939.

* * * * *

§ 1.172–5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) *Taxable year subject to the Internal Revenue Code of 1954.* The taxable income for any taxable year subject to the Internal Revenue Code of 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year is computed with the modifications prescribed in this paragraph. These modifications shall be made independently of, and without reference to, the modifications required by §§ 1.172–2(a) and 1.172–3(a)

for purposes of computing the net operating loss itself.

(1) *Modifications applicable to corporations only.* In the case of a corporation the deductions provided by section 242 (relating to partially tax-exempt interest) and by section 922 (relating to Western Hemisphere trade corporations) shall not be allowed.

* * * * *

(3) *Modifications applicable to all taxpayers.* In the case either of a corporation or of a taxpayer other than a corporation—

(i) *Net operating loss deduction.* The net operating loss deduction for such taxable year shall be computed by taking into account only such net operating losses otherwise allowable as carrybacks or carryovers to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the taxable income is to be deducted. Thus, for such purposes, the net operating loss for the loss year or any taxable year thereafter shall not be taken into account.

Example. The taxpayer's income tax returns are made on the basis of the calendar year. In computing the net operating loss deduction for 1954, the taxpayer has a carryover from 1952 of $9,000, a carryover from 1953 of $6,000, a carryback from 1955 of $18,000, and a carryback from 1956 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the net operating loss deduction for 1954, for purposes of determining the tax liability for 1954, is $43,000. However, in computing the taxable income for 1954 which is subtracted from the net operating loss for 1955 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $15,000, that is, the aggregate of the $9,000 carryover from 1952 and the $6,000 carryover from 1953.

In computing the net operating loss deduction for such purpose, the $18,000 carryback from 1955 and the $10,000 carryback from 1956 are disregarded. In computing the taxable income for 1954, however, which is subtracted from the net operating loss for 1956 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $33,000, that is, the aggregate of the $9,000 carryover from 1952, the $6,000 carryover from 1953, and the $18,000 carryback from 1955. In computing the net operating loss deduction for such purpose, the $10,000 carryback from 1956 is disregarded.

(ii) *Recomputation of percentage limitations.* Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the taxable income or adjusted gross income, as the case may be, determined with the modifications prescribed in this paragraph. Thus, in the case of an individual the deduction for medical expenses would be recomputed after making all the modifications prescribed in this paragraph, whereas the deduction for charitable contributions would be determined without regard to any net operating loss carryback but with regard to any other modifications so prescribed. See, however, the regulations under paragraph (g) of § 1.170–2 (relating to charitable contributions carryover of individuals) and paragraph (e) of § 1.170–3 (relating to charitable contributions carryover of corporations) for special rules regarding charitable contributions in excess of the percentage limitations which may be treated as paid in succeeding taxable years.

Example (1). For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $4,800, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income)	200	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income)	1,400	
		2,200
Taxable income		4,800

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. Under section 172 (b)(2), it is determined that the entire $3,000 is a carryback to 1954. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957, the taxable income for 1954 as computed under this paragraph is $3,970, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		6,000
Less:		
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income as modified under this paragraph)	$230	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income determined with all the modifications prescribed in this paragraph other than the net operating loss carryback)	1,800	
		2,030
Taxable income		3,970

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Example (2). For the calendar year 1959 the taxpayer, an individual, files a return showing taxable income of $5,700, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Standard deduction allowed by section 141	700	
		1,300
Taxable income		5,700

In 1960 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $4,700. In 1961 he sustains a net operating loss of $10,000 in the operation of the business. Under section 172(b)(2), it is determined that the entire amount of each loss, $4,700 and $10,000, is a carryback to 1959. In determining the amount of the carryover of the 1961 loss to 1962, the taxable income for 1959 as computed under this paragraph is $3,870, determined as follows:

Salary	$5,000
Net long-term capital gain	4,000
Total gross income	9,000
Less: Deduction for carryback of 1960 net operating loss	4,700
Adjusted gross income	4,300
Less: Standard deduction	430
Taxable income	3,870

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